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IN THE

SUPREME COURT OF THE UNITED STATES

FEBRUARY TERM, 1975

No. 74-1039

JOSEPH B. ZYCHINSKI and MARIE H. ZYCHINSKI,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ESTATE OF HENRY J. RICHTER, ERMA A. RICHTER and NANCY MONSON,
Executrices, and ERMA A. RICHTER, Individually,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
for the Eighth Circuit

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The taxpayers-petitioners in these related cases, Joseph B. Zychinski and Marie H. Zychinski and the Estate of Henry Richter, deceased, Erma A. Richter and Nancy Monson, Executrices, and Erma A. Richter, individually, hereby petition for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in these cases.

OPINIONS BELOW

The opinion of the United States Tax Court (Appendix A, infra, pp. A-1 to A-13, inclusive) in favor of the Commissioner of Internal Revenue is reported at 60 T.C. 950. The opinion of the Court of Appeals for the Eighth Circuit (Appendix B, infra, pp. A-14 to A-18, inclusive) affirming the Tax Court is reported at —F.2d—.

JURISDICTION

The opinion and judgment of the Court of Appeals were entered on November 25, 1974. Taxpayers' petition for rehearing was timely filed on December 9, 1974, and was denied on December 17, 1974 (Appendix C, infra, p. A-19). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Are the "passive investment income" termination provisions of Subchapter S, as contained in Section 1372(e)(5) of the 1954 Internal Revenue Code, as amended, applicable to the receipts of a business corporation derived from the conduct of that business, without regard to the fact that the receipts are derived neither "passively" nor from "investment" sources.

STATUTES AND REGULATIONS INVOLVED

Section 1372(e)(5) of the Internal Revenue Code of 1954, in its entirety, and the pertinent portions of U.S. Treasury Regulations on Income Tax (Section 1.1372-4(b)(5)(x)) are set forth in Appendix D, infra, pp. A-20 to A-21, inclusive.

of Richter and Company had terminated because the receipts of Richter and Company constituted "passive investment income" under Section 1372(e)(5) of the 1954 Internal Revenue Code as amended. It is agreed that if Richter and Company was a valid Subchapter S corporation during 1966 and 1967 the taxpayers were entitled to the net operating loss deductions claimed on their individual returns.

The Tax Court sustained the position of the Commissioner of Internal Revenue that the election of Henry J. Richter and Company had terminated. In its opinion (Appendix D, infra, pp. A-20), the Tax Court noted taxpayers' position that the termination provisions of Subchapter S were not intended to be applicable to corporations conducting active business operations (but were intended by Congress to deny the election to businesses with large amounts of investment type income such as royalties, rents, dividends, annuities and profits from the sale or exchange of stocks or securities) and noted that this position had been upheld by the Court of Appeals of the Fifth Circuit in *House v. Commissioner*, 453 F.2d 982 (CA 5 1972). However, the Tax Court concluded it would not follow *House v. Commissioner*.

The Court of Appeals for the Eighth Circuit affirmed the position of the Tax Court stating that in its view the applicable statute, Section 1372(e)(5), contained definitional language which, under that statute, caused the Subchapter S election of Richter & Co. to terminate.

REASONS FOR GRANTING THE WRIT

1. The issue presented in this case concerns the proper interpretation of the termination provisions contained in Section 1372(e)(5) of the 1954 Internal Revenue Code applicable to Subchapter S corporations. The decision of the Court of Appeals below holding that the termination provision of 1372(e)(5) are applicable to certain small business corporations adopting Subchapter S treatment, regardless of the fact that such businesses conduct active business operations and do not realize passive investment income in the ordinarily understood sense, has created a direct conflict with the decision of the Court of Appeals for the Fifth Circuit in *House v. Commissioner*, 453 F.2d 982, which decision held that the termination provisions of 1372(e)(5) are not applicable unless the income receipts of a corporation were "passive" in the commonly understood sense.[1] The availability of taxation as a Subchapter S corporation is a very important matter to numerous small business corporations, and in particular to those corporations conducting a small loan business or a securities dealership business, and resolution of this conflicting interpretation of Section 1372(e)(5) of the Internal Revenue Code and the appropriateness of standards of applicability, is therefore highly important to the orderly administration of the tax laws. Moreover, this conflicting interpretation among different Courts of Appeals falls within the purview of Rule 19-1(b) of the Rules of this Court, which indicates that such a conflict will be considered in granting a Writ of Certiorari.

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[1] Since the decision of the Appellate Court below, the United States Court of Appeal for the Tenth Circuit has rendered its decision in *Marshall v. Commissioner*, — F.2d —, 75-1 USTC Par. 9160, affi'g. 60 T.C. 242, in which the Tenth Circuit Court of Appeals sided with the Eighth Circuit Court of Appeals and held that the termination provisions of Section 1372(e)(5) were applicable in the case of a Subchapter S corporation actively engaged in the small loan business.

The Internal Revenue Code provisions relating to Subchapter S corporations were initially enacted by Congress in 1958. The legislative history attendant to this statute, as contained in Senate Report to the Technical Amendments Act of 1958, Section 68, 1958-3 Cum. Bul. 1008, clearly indicates that congress intended Subchapter S status to be available to corporations conducting active business operations and further intended to deny this status to businesses with large amounts of investment type income such as royalties, rents, dividends, interests, annuities and profits from the sale or exchange of stocks and securities. Therefore, Section 1372(e)(5) was adopted to prevent such corporations with substantial passive investment income to qualify as a Subchapter S corporation. Section 1372(e)(5), as originally enacted, provided for termination of Subchapter S status where sufficient receipts of a corporation constituted "personal holding company income."[2] The 1966 Amendment to Section 1372(e)(5) (Public Law 89-389) changed the heading of Paragraph (5) from "Personal Holding Company Income" to "Passive Investment Income" without specifying any reason for the change in terminology; however, the applicable Senate Committee Report did say: "New Subparagraphs (A) and (C) of Section 1372(e)(5) contain the *same general rule as existing law*." Senate Report No. 1007, 89th Congress, 2d Session (1966), 1966-1 Cum. Bul. 527, 541. (Emphasis supplied.)

The court below in the instant case, as well as the Court of Appeals for the Tenth Circuit in *Marshall v. Commissioner*,

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[2] Section 1372(e)(5) as originally enacted provided:

> 5. *Personal Holding Company Income*—An election under Subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20% of which is derived from royalties, rents, dividends, interests, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). * * *

supra, have read Section 1372(e)(5) quite narrowly, indicating that since the Section purports to contain a definition of "passive investment income" any other interpretation is precluded. On the other hand, the position of the Court of Appeals for the Fifth Circuit, as set forth in *House v. Commissioner*, supra, which petitioners herein believe to be the correct interpretation of Section 1372(e)(5), is that Congress used the term "personal holding company income" and "passive investment income" in identifying the kind of income that would terminate the Subchapter S status of a corporation and that these terms were employed by Congress to make clear its legislative purpose and that such terms cannot be read in isolation. The Commissioner's position in *House*, that as a matter of statutory construction the words "passive investment income" apply to interest (or on a comparable basis to sales or exchanges of securities) was squarely rejected by the Fifth Circuit which held that the Commissioner would not be permitted to lift or isolate certain words from their context to give them a meaning that does violence to Congressional purpose.

2. The effect of the decision of the court below (as well as the decision of the Court of Appeals for the Tenth Circuit in *Marshall v. Commissioner*, supra), is to prevent certain businesses (such as securities dealers and small loan companies) which actively conduct a business operation from ever qualifying as Subchapter S corporations. In the case of a securities dealer involved in the case below, such a securities dealer is merely a merchant who purchases his stock in trade (i.e. securities) with the expectation of reselling at a profit (and not because of intervening rises in value), with the markup representing remuneration to the securities dealer for his labors as a middle man in bringing buyer and seller together. See *Stephens, Inc. v. United States*, 464 F.2d 53 (CA8, 1972), *George R. Kemon v. Commissioner*, 16 T.C. 1026 (1951). Thus the "doubt" expressed by the Court below in footnote 10 of its

opinion is ill-founded for the reason that market fluctuations are not the basis by which a securities dealer is compensated; but it is rather as a middleman-merchant who performs a marketing service. The opinion of the Court of Appeals below indicates some reservation that taxpayer's position "leaves room for considerable ambiguity, particularly as to standards for determining whether a securities (or other) dealer is sufficiently 'active' in the pursuit of its business to warrant Subchapter S treatment". However, there is absolutely no cause for such concern since the only requirement would be a factual determination that a particular taxpayer (such as a securities dealer or lending company) was actively engaged in that business. This factual determination is a frequent requirement for the applicability of various sections of the Internal Revenue Code, for example the deduction of trade or business expenses under Section 161, the special rules for determining capital gains treatment under Section 1231(b), the applicability of special inventory rules applicable to securities dealers under U.S. Treasury Regulations 1.471-5 etc. Therefore the problem of determining the active status of a corporate business is a common problem in the administration of the Internal Revenue Code provisions, and it is not unique with the Subchapter S termination provisions of Section 1372(e)(5).

The findings in the instant case are undisputed that during the years in issue, Henry A. Richter & Company bought for and sold from inventory only and held no stocks for investment (although it did hold such investment stocks in later years which were clearly identified as such). The fact that the inventory of Henry J. Richter & Company was subject to market fluctuation is of no consequence since this attribute is also present with respect to inventories of other corporate merchants all of whom qualify for Subchapter S treatment, such as livestock dealers, precious metal dealers, grain dealers and food brokers. By preventing a securities dealer (and small loan

company) from enjoying Subchapter S corporate status, the Court below and the Court of Appeals for the Tenth Circuit have interpreted Section 1372(e)(5) in such a manner as to cause discriminatory treatment among business, where there is absolutely no indication of Congressional intent to exclude certain businesses from benefits of Subchapter S. See *House v. Commissioner*, supra.

3. The basis of the holding of the Court of Appeals below (as well as that of the Tenth Circuit) appears to have been that the definitional provisions of Section 1372(e)(5)(C) relating to "sales or exchanges of stock or securities" and "interest" are complete; however, the result of these decisions is to lift or isolate the terms "sales or exchanges of stock or securities" and "interest" from their context, and to give these terms a meaning that does violence to congressional purpose. Moreover, such interpretations completely ignore the words "passive investment income" which were deliberately utilized by Congress to make clear its purpose and intention concerning this particular statute. *House v. Commissioner*, supra.

An additional effect of the ruling of the court below (as well as the ruling of the Court of Appeals for the Tenth Circuit in *Marshall v. Commissioner*) is that the result achieved thereby necessarily presumes a substantive change in the termination provisions of Section 1372(e)(5) as a result of the 1966 amendment to the statute (P.L. 89-389), since neither a securities dealer nor small loan company would come within the purview of a personal holding company. See *House v. Commissioner*, supra. However, such a presumed statutory change is inconsistent with the Senate Report to the statute indicated above and indicated in footnote 6 of the Tax Court opinion below (Appendix A-9), which clearly indicates that the statutory version contains the same general rule as existing law. Therefore, it is clear that no changes in the substance of the

termination provisions were intended by the 1966 amendment (which added subparagraph (C) to Section 1372(e)(5)), and any indication that such a change resulted can not be a correct interpretation of the statute in question.

4. The Commissioner of Internal Revenue has been inconsistent in his interpretation of the termination provisions of Section 1372(e)(5). While the court below, in the case of "the sale or exchange of stocks and securities" (as well as the Court of Appeals for the Tenth Circuit in the case of "interest") has apparently accepted the Commissioner's argument that it is not permitted to "look behind the normal characterization of a corporation's receipts in order to classify them as active or passive", the fact remains that in the case of "rents" (also part of the same applicable statute), the Commissioner has issued regulations and rulings which do in fact look behind the "normal characterization" of the receipts to determine whether business activities and services are present so as to avoid termination of a corporation's Subchapter S status. Seago, *Passive Income Limitations Under Subchapter S*, 52 Taxes, The Tax Magazine 112 (1974). Thus, taking into account the facts of each case, the Commissioner of Internal Revenue has ruled that rental payments received by a hotel corporation, warehouse company or property rental corporation are not "rents" for the purposes of the Subchapter S termination provisions of Section 1372(e)(5) of the 1954 Internal Revenue Code. U. S. Treasury Regulations Section 1.1372-4(p)(vi); Rev. Rul. 65-40, 1965 Cum. Bul. 429; Rev. Rul. 65-83, 1965-1 Cum. Bul. 450; Rev. Rul. 72-206, 1972-1 Cum. Bul. 177. There is no reason why the Commissioner should adhere to a strict characterization in the case of securities dealers and finance companies, but nevertheless look to the facts of each situation in the case of rents. While the opinion of the court below notes that the development of standards in this area is with the Commissioner, certainly the Commissioner has the duty of treating all taxpayers

similarly situated in a uniform and like-handed manner. In fact, the opinion of the court below notes (Appendix A-7) that the position of the Tax Court (which sustained the Commissioner of Internal Revenue) has been subject to criticism.

As indicated above, the effect of the ruling of the court below has been to create a conflict, and an indication of the confusion which has resulted in the administration and interpretation of Section 1372(e)(5) is shown by two recent decisions of the Tax Court in related cases concerning the Subchapter S status of a small loan company. In these cases involving two shareholders of the *same* corporation, the Tax Court reached opposite results, holding that the Subchapter S status did not terminate in the case of the taxpayer residing within the Fifth Circuit, and further holding that the Subchapter S status of the same corporation for the same year did terminate in the case of a taxpayer residing within the Eighth Circuit. *Puckett v. Commissioner*, 1974 T.C. Memo No. 235; *Doehring v. Commissioner*, 1974 T.C. Memo No. 234.

Petitioners earnestly submit that the issue presented in this case as a most significant one affecting many taxpayers who operate small businesses in corporate form, and as matters presently stand, the termination provisions of Section 1372(e)(5) have been interpreted in different ways by different Courts of Appeals resulting in conflicting interpretations and in non-uniform results among taxpayers similarly situated. The granting of Certiorari in this case will permit the Supreme Court to remove the conflict that has developed and to render a uniform and proper interpretation of Section 1372(e)(5) in its applicability to small business corporations.

CONCLUSION

This petition for a Writ of Certiorari should be granted.

Respectfully submitted

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APPENDIX A

FINDINGS OF FACT AND OPINION

(Filed September 20, 1973)

60 T. C. No. 100

United States Tax Court

Joseph B. Zychinski and Marie H. Zychinski, et al.,[1] Petitioners

v. Commissioner of Internal Revenue, Respondent

Docket Nos. 882-72, 883-72 Filed September 20, 1973

Petitioners were shareholders of an electing small business corporation which was actively engaged in the securities business. More than 20 percent of its gross receipts for the years in issue consisted of gains from sales or exchanges of stocks or securities in the ordinary course of business. *Held*, such gains constituted "passive investment income" as defined in Section 1372(e)(5), so that the corporation's status as a small business corporation was terminated in the years in issue.

Harvey G. Schneider, for the petitioners.

Matthew W. Stanley, for the respondent.

Hall, Judge: Respondent determined deficiencies in the Federal income taxes of Joseph B and Marie H. Zychinski and the Estate of Henry J. Richter, Deceased, and Erma A. Richter, as follows:

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[1] Consolidated herewith is Estate of Henry J. Richter, Dec'd., Erma A. Richter and Nancy Monson, Co-Executrices, and Erma A. Richter, Surviving Spouse, Docket No. 883-72.

Petitioners	Year	Deficiency
Joseph B. and	1966	$1,031.25
Marie H. Zychinski	1967	229.97
	Total	$1,261.22
Estate of Henry J.	1963	$ 19,256
Richter, Deceased, and	1964	96,728
Erma A. Richter	1966	6,644
	1967	2,802
	Total	$125,430

The sole issue is whether more than 20 percent of the gross receipts of Henry J. Richter & Company for its fiscal year ending October 31, 1966, constituted passive investment income within the meaning of section 1372(e)(5),[2] with the result that the Company's status as an electing small business corporation was terminated for such year and succeedings years.

Findings of Fact

Some of the facts have been stipulated and are found accordingly.

Petitioners, Joseph B. and Marie H. Zychinski, husband and wife, resided in St. Louis, Missouri when they filed their petition in this case. They filed joint Federal income tax returns for the taxable years 1966 and 1967 with the district director of internal revenue at St. Louis.

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[2] All Code references are to the Internal Revenue Code of 1954, as in effect during the years in issue.

Erma A. Richter and Nancy Monson are co-executrices of the Estate of Henry J. Richter, who died on August 8, 1970. The Estate of Henry J. Richter is being probated in St. Louis County, Missouri. Erma A. Richter, decedent's surviving spouse, resided in St. Louis, Missouri, when in her capacity as co-executrix and surviving spouse she filed her petition in this case. Henry J. and Erma A. Richter filed joint Federal income tax returns for the years 1963, 1964, 1966 and 1967 with the district director of internal revenue at St. Louis.

Marie H. Zychinski and Erma A. Richter are parties to this proceeding solely by virtue of having filed joint returns with their husbands.

Henry J. Richter & Company (hereinafter "Richter & Co.") was incorporated under the laws of Missouri on July 31, 1964. According to its October 31, 1966 tax return, it had 4,000 shares of stock issued and outstanding. Henry J. Richter was president and the parties have stipulated that he owned all but 101 shares of the issued and outstanding stock of Richter & Co. Petitioner Joseph B. Zychinski was treasurer and the owner of 100 shares of Richter & Co.[3] Richter & Co. maintained its books and records and reported its income on a fiscal year ending October 31. For its fiscal years ended October 31, 1966 and 1967, it timely filed Federal income tax returns with the district director of internal revenue at St. Louis. Prior to the commencement of its fiscal year ended October 31, 1966, Richter & Co. had filed a valid election to be taxed as a small business (subchapter S) corporation, and during the years ending October 31, 1966 and 1967, considered itself still to be a valid subchapter S corporation.

During fiscal years 1966 and 1967, Richter & Co. was actively engaged in the securities business. Its principal office

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[3] According to Richter & Co.'s 1966 return, Zychinski owned 135 shares. The discrepancy between this and the stipulation is unexplained, but is immaterial for present purposes.

was in St. Louis, and it maintained branch offices in San Francisco, Los Angeles and New York, and operated correspondent relationships with other securities firms in Denver, Cleveland, Dallas, and Chicago.

Richter & Co.'s business activities consisted primarily of two functions: (1) the trading of stocks or securities, with respect to which the Company acted as a principal by purchasing and selling for its own account; and (2) the placing of purchase and sales orders as a broker or agent on a commission basis for listed and over-the-counter securities on behalf of a customer. In addition, Richter & Co. engaged in some underwriting of new and existing issues of securities, and operated as an intermediary in connection with mergers and acquisitions of various companies.

The greater part of Richter & Co.'s activities was devoted to the purchase and sales of stocks or securities for its own account, for and from the inventory which it maintained for that purpose. The majority of sales of securities from its inventory were "wholesale" sales, meaning sales to broker-dealers. A minority of sales were "retail" sales, meaning sales to buyers who were not broker-dealers.

During the years in issue, Richter & Co. purchased and sold and maintained an inventory of 50 to 100 different securities traded in the over-the-counter market. Richter & Co. "made a market" in these over-the-counter securities. "Making a market" in such securities meant that the Company, as a qualified securities dealer, in accordance with the practices of the securities industry, had published and advertised in trade circles that it would buy or sell such securities from and to other securities dealers, either purchasing for its inventory or selling from its inventory of such securities, and was required to make purchases and sales in accordance with industry practice. From this inventory of securities, Richter & Co. conducted a busi-

ness of wholesaling the securities to other brokerage firms on a national basis.

Richter & Co. did not purchase any securities for investment during the years in issue. No sales of securities were reported on the Company's tax returns for the years in issue as capital transactions. In subsequent years, when the Company did buy securities for investment, it segregated and recorded such purchases in an investment account and did not commingle them with inventory. Sales of such investment securities were reported on the Company's tax returns as capital transactions.

Richter & Co.'s receipts during the taxable years in issue had several components. Minor items included dividends and interest earned on its wholly or jointly owned securities. The Company also received commission income, its compensation for services rendered with respect to its underwritings and brokerage functions.

The principal component, however, was the gains generated by Richter & Co.'s trading for its own account. Gains were treated and recorded in two of the Company's general ledger accounts, one designated the "retail profit" account, and the other the "trading profit" account. The "retail profit" account, some $79,000 in gross amount in fiscal 1966, represented only a portion of the Company's gains on retail sales. Gains on retail sales other than that portion recorded in the "retail profit" account were recorded in the "trading profit" account. Thus, the Company's "trading profit" of approximately $155,000 in fiscal 1966 represented gains on both wholesale and retail sales. The figure of $155,000 is a net amount, losses having been offset against gains, resulting from hundreds of transactions. The Company's gains on securities trading for its own account amounted to far more than 20 percent of its gross receipts.

Richter & Co. was registered with Securities and Exchange Commission as a broker-dealer; was a member of the Midwest Stock Exchange; was registered by the City of St. Louis to carry on the business of investment securities; and was a member of the National Association of Securities Dealers, Inc., among other securities associations to which it belonged.

During the years in issue, Richter & Co. on a continuous basis advertised in such trade publications as the Financial Chronicle, the TWX Guide, the Traders Guide and the Investment Dealers Digest, and in the Wall Street Journal and the financial sections of the St. Louis newspapers. In addition, Richter & Co. maintained listings in the listings service (generally referred to as the Pink Sheets, and also the Green Sheets for broker-dealers in western states) utilized by securities dealers and brokers (as published by the National Quotation Bureau, Incorporated) wherein the Company listed the securities that it was offering to purchase and sell at the time of listing (together with bid and asked prices). This listings service was generally circulated among securities brokers, securities dealers and other financial institutions.

Richter & Co. ceased operation in May 1970 when involuntary bankruptcy proceedings were instituted by the Securities and Exchange Commission because the Company failed to comply with the Securities and Exchange Commission's net capital requirements. The bankruptcy proceedings are presently pending in the United States District Court for the Eastern District of Missouri.

Richter & Co. reported net operating losses of $170,283 and $152,712 for its fiscal years ended October 31, 1966 and 1967, respectively. On their 1966 and 1967 returns, Henry J. and Erma A. Richter claimed deductions of $164,536 and $148,321, respectively, as their pro rata share of the net operating losses sustained by the Company for its fiscal years ended October 31, 1966 and 1967. As a result of these losses, they claimed and

timely filed application for net operating loss carrybacks to 1963 and 1964.

On their 1966 and 1967 returns, petitioners Joseph B. and Marie H. Zychinski claimed deductions of $5,747 and $1,074, respectively, as their pro rata share of the net operating losses sustained by the Company for its fiscal years ended October 31, 1966 and 1967.

The parties agree that if this Court holds that Richter & Co. was a valid subchapter S corporation in 1966 and 1967, petitioners are entitled to the net operating loss deductions claimed on their returns.

Opinion

The parties are in agreement on the fact that over 20 percent of the gross receipts of Richter & Co. for its fiscal year ended October 31, 1966 came from its profits on securities trading. The questions of the corporation's qualification as a subchapter S corporation is one of law, turning on the construction of section 1372(e)(5), defining passive investment income.[4]

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[4] Section 1372(e)(5), as in effect for the years in issue in this case and prior to its amendment by Public Law 91-683 (January 12, 1971), provided:

> (5) Passive investment income.—
>
> (A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.
>
> (B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross

Petitioner contends that section 1372(e)(5) was never intended to prevent an active business from being a subchapter S corporation, and, therefore, contrary to the literal language of that section, receipts derived from "sales or exchange of stock or securities" by a securities dealer like Richter & Co. do not constitute "passive investment income."

Respondent reads section 1372(e)(5) literally, pointing out that it specifically defines "passive investment income" to include receipts derived from "sales or exchanges of stock or securities," without specifying that such receipts must be derived from inactive operations. We agree with respondent.

The parties agree that Richter & Co. was an active business operation, that more than 20 percent of its gross receipts was derived from the sale of securities, and that it was a valid subchapter S corporation for its fiscal year ended October 31, 1966, unless its election to be such was terminated under section 1372(e)(5).

Petitioner first argues that the legislative history of subchapter S[5] clearly indicates that subchapter S status is to be available to corporations conducting active business operations,

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receipts more than 20 percent of which is passive investment income, if—

(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year, and

(ii) the amount of passive investment income for such taxable year is less than $3,000.

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

[5] S. Rept. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 922, 932-933.

whereas Congress intended to deny the election to businesses with large amounts of investment type income such as royalties, rents, dividends, interest, annuities and profits from the sale or exchange of stocks and securities. Moreover, petitioner notes, the Fifth Circuit in *House v. Commissioner*, 433 F. 2d 982 (C.A. 5, 1970), reversing a Memorandum Opinion of this Court, has so held."

Moreover, petitioner claims *House v. Commissioner, supra*, is the only case directly in point. The question presented in that case was whether certain corporations engaged in the small loan business lost their subchapter S status by virtue of the fact that the income received from their business operations constituted interest. The Fifth Circuit, in reversing the Tax Court, held that the Tax Court had "erred in finding that lending and finance companies actively engaged in the business of making

[1] Section 1372(e)(5) as originally enacted provided:

> (5) Personal Holding Company Income.—An election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

The 1970 amendment (Public Law 91-258) changed the heading of paragraph (5) from "Personal Holding Company Income" to "Passive Investment Income" without specifying any reason for the change in terminology. However, the Senate Committee Report did say: "New subparagraphs (A) and (B) of section 1372(e)(5) continue the same general rule as existing law." S. Rept. No. 1533, 91st Cong., 2d Sess. (1970), 1970 C.B. 721, 741. The 1970 amendment applies to taxable years of Subchapter S corporations ending after April 14, 1970, including the year in issue here.

[2] *House v. Commissioner*, 433 F. 2d 982 (C.A. 5, 1971), dealt with Section 1372(e)(5) prior to the 1970 amendment, but the effect, if any, of such amendment was considered by the Fifth Circuit in its opinion.

loans are subject to the subchapter S termination provisions of section 1372(e)(5) * * *." In *House, supra* at 985, the Commissioner argued, as he does here, that:

> The language of Section 1372(e)(5) is clear. It states that the Subchapter S status of a company will terminate if more than 20 percent of its gross receipts in a taxable year is derived from interest. There is nothing vague or confusing in such language. *The statute makes no "passive" interest versus "active" interest distinction. It just says interest.* No reference is made in the statute to the personal holding company tax provisions, and there is no legislative history indicating that such a reference was intended. The test imposed is an objective, mathematical one.
>
> * * * * * * *
>
> Thus, whether or not the interest received by loan companies *be considered "active" or "passive" income*, it is still interest, and interest is specifically included in the Subchapter S termination provision of Section 1372(e)(5) * * *. (Emphasis in the original.)

However, the Fifth Circuit concluded that "the words 'personal holding company income' and 'passive investment income' were deliberately employed by Congress to make clear its legislative purposes," and that the word "interest" could not be read in "isolation." Rather, to "give purpose to the entire Congressional Act," the Fifth Circuit held that interest earned by a small loan company was not "passive investment income."

Since the parties filed their briefs in this case, this Court has, by reviewed decision, concluded it will not follow *House v. Commissioner, J. J. Marshall*, 60 T.C. No. 29 (1973). In *Marshall* we stated:

> [W]e specifically held in *Buhler Mortgage Co.* that the fact that active efforts might have been exerted to produce

> interest or rental income did not cause that income not to be "personal holding company income" or "passive investment income" under the provisions of section 1372(e)(5). We further held that the fact that an exemption of certain income or a certain type of income from the provisions of the personal holding company income under section 543 did not cause a similar exclusion to exist under section 1372(e)(5). In our view our holding in *Buhler Mortgage Co.* which has now been affirmed per curiam by the United States Court of Appeals for the Ninth Circuit (443 F. 2d 1362), cannot be reconciled with the holding of the Fifth Circuit in *House v. Commissioner, supra.* We therefore respectfully decline to follow the Appeals Court's holding in the *House* case and conclude that interest and rental income are part of "passive investment income" even though the recipent of such interest or rental income may be actively engaged in a small loan or real estate business.

And so we conclude here, as we did in *Buhler Mortgage Co.*, 51 T.C. 971, 977-978 (1969), that:

> Though we agree with petitioner that the subchapter S provisions were not intended to include corporations with large amounts of investment-type income (as opposed to those actively engaging in trades or businesses) we cannot find that the nature of the income changes simply because the corporation earning it must engage in many activities and exert a great deal of effort in doing so. The standard used by the Code and the regulations does not permit us to look behind the normal characterizations of a corporation's receipts in order to classify them as active or passive. If this were not so, we can only guess at what criteria might be properly used to say, e.g., that a rent item was "active" because the tenant was such poor pay, or that a dividend item was "active" because a stockholder's

> bill had to be brought to force the directors to declare and pay it. We conclude that the test established is one which requires us to look only to the plain meaning of the words used to define the income, not to the activity required to produce it.

Petitioner also argues that, granted "passive investment income" includes receipts derived from "sales or exchanges of stock or securities," such term does not apply to ordinary gross receipts received by a securities dealer in the ordinary course of business, but rather was intended to refer only to transactions involving capital assets.

Moreover, petitioner argues, respondent's regulation (section 1.1372-4(b)(5)(x), Income Tax Regs.) which provides in part as follows:

> Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities.

is not inconsistent with petitioner's alternative position. The sales of securities by a securities dealer referred to in the regulations, argues petitioner, refer not to sales in the regular course of its business, but to dealer's sales of investment securities which are capital assets of the dealer and not inventory.

The basic problem with petitioner's argument is that the language of section 1372(e)(5) nowhere limits "sales or exchanges of stock or securities" to capital assets, nor does it differentiate between trade or business activity and nonbusiness activity. "Sale or exchange" is frequently used in the Code in connection with proprety held for sale to customers in the ordinary course of business. See, for example, section 1236 which provides in part that gain derived by a securities dealer from sales or exchanges of securities is ordinary income unless the

security is clearly identified in the dealer's records as held for investment. See also section 1.61-6(a), Income Tax Regs., which defines gross income as including "Gain realized on the sale or exchange of property * * *."

Furthermore, we find respondent's regulation, explicitly applying section 1.372(e)(5) to regular dealers in stocks and securities, to be resaonable and consistent with the language of the statute.

In accordance with the foregoing.

Decision will be entered under Rule 50.

APPENDIX B

Before Gibson, Chief Judge, Bright, Circuit Judge, and Talbot Smith,* Senior District Judge.

Talbot Smith, Senior District Judge.

These appeals are taken from judgments of the United States Tax Court assessing tax deficiencies against the taxpayers of some $1,300 in No. 74-1180 and some $125,000 in No. 74-1181. The facts are not in dispute and are set out in more detail in the opinion of the tax court.[1] The issue presented involves the interpretation of Int. Rev. Code of 1954, § 1372 (e)(5), relating to the termination of a corporation's "subchapter S" status.[2] In 1966 and 1967 Henry J. Richter & Company, Inc. (hereinafter the Company) reported net operating losses which it attempted to pass through to its shareholders, the taxpayers here, under subchapter S. The Commissioner argued and the tax court held, however, that the Company's subchapter S status had terminated under Int. Rev. Code of 1954, § 1372 (e)(5) since in 1966 more than twenty percent of its "gross receipts" were "passive investment income," to-wit: gains from the "sales or exchanges of stock or securities."

As applicable to the years in question § 1372(e)(5) provided:

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* Talbot Smith, Senior District Judge, Eastern District of Michigan, sitting by designation.

[1] *Zychinski v. Commissioner*, 60 T.C. No. 100 (1973).

[2] Subchapter S, Int. Rev. Code of 1954, §§ 1371-9, added to the Code in 1958, permits certain corporations to elect to be taxed as a partnership or proprietorship: the net income (or loss) of the business is "passed through" to the shareholders without a corporate tax.

We have not been unmindful of the criticisms leveled at the tax court's position.[8] Principally, it is urged that it serves no substantive purpose and is unfair to deny subchapter S benefits to an actively conducted business. Support for this position is said to be found in certain congressional comments on § 1372 (e)(5) which summarize its effect as limiting "the availability of [subchapter S] treatment to small businesses actively engaged in trades or businesses."[9] We are not persuaded, however, that such generalizations from the legislative history can override the plain meaning of the specific language of the statute.

Moreover, we find ample procedural grounds supporting the result we here reach. The tax laws must be administered with some precision and predictability. The statute and regulation as

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[8] Seago, *Passive Income Limitations Under Subchapter S*, 52 Taxes 112 (1974); *see House v. Commissioner*, 453 F.2d 982 (5th Cir. 1972); *Valley Loan Ass'n v. United States*, 258 F. Supp. 673 (D. Colo. 1966).

[9] S. Rep. No. 1007, 89th Cong., 2nd Sess. 8 (1966); H. Rep. No. 1238, 89th Cong., 2nd Sess. 8 (1966). The complete context of the quotation is as follows:

> When the "passthrough" type of tax treatment was provided for corporations, Congress decided to limit the availability of this treatment to small business actively engaged in trades or businesses. Therefore, it denied this treatment to corporations with large amounts of passive income. Accordingly present law (sec. 1372(e) (5)) provides that a "passthrough" election is to terminate automatically where more than 20 per cent of a corporation's gross receipts are derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

This language does not illuminate the ultimate congressional purpose which, we find, is somewhat obscure. The most recent committee pronouncements on the subject speculate that the provision was aimed a rather limited potential abuse: the incorporation of "one's investment activities merely to obtain tax federal deferral benefits accorded to pension, profit sharing, and similar plans." In view of recent changes in pension taxation for subchapter S corporations, the reports suggest, this need for the provision has largely disappeared. Studies to eliminate it entirely are underway. S. Rep. No. 91-1535, 91st Cong., 2nd Sess. 2 (1970); H. Rep. No. 91-1735, 91st Cong., 2nd Sess. 2 (1970).

here interpreted meet this test. The taxpayer's proposed interpretation, on the other hand, leaves room for considerable ambiguity, particularly as to standards for determining whether a securities (or other) dealer is sufficiently "active" in the pursuit of its business to warrant subchapter S treatment.[10] At minimum, the development of standards in this area is in the first instance for the Commissioner.[11] We find no unfairness to the taxpayers in treating them in accordance with Treas. Reg. § 1.1372-4(b)(5)(x)(1959) which, in substance, specifically alerted the Company that its subchapter S status would be terminated in the circumstances here presented.

The judgment is affirmed.

A true copy.

Attest

Clerk, U.S. Court of Appeals, Eighth Circuit

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[10] We have some doubt, even by a colloquial definition, whether income derived from the fluctuation of a market price may be characterized as "active."

[11] *E.g.*, Treas. Reg. § 1.1372-4 (b)(5)(vi)(1959) dealing with the meaning of "gross receipts derived from * * * rents" under § 1372(e)(5)(C).

APPENDIX C

United States Court of Appeals for the Eighth Circuit

September Term, 1974

No. 74-1180.
Joseph B. Zychinski and Marie H. Zychinski,
Appellants,
vs.
Commissioner of Internal Revenue,
Appellee.

No. 74-1181.
Estate of Henry J. Richter, Deceased, et al.,
Appellants,
vs.
Commissioner of Internal Revenue,
Appellee.

The Court having considered petition for rehearing en banc filed by counsel for appellants and, being fully advised in the premises, it is ordered that the petition for rehearing en banc be, and it is hereby, denied.

Considering the petition for rehearing en banc as a petition for rehearing, it is ordered that the petition for rehearing also be, and it is hereby, denied.

December 17, 1974

APPENDIX D

1954 Internal Revenue Code

Section 1372—Election by Small Business Corporation.

* * * * * * *

(e) Termination

(5) Passive Investment income—

(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

(ii) the amount of passive investment income for such taxable year is less than $3,000.

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from

sales or exchanges or stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation.

* * * * * * *

U. S. Treasury Regulations Sec. 1. 1372-4(b

(x) *Gross receipts from the sale of stock or securities.* For purposes of section 1372(e)(5), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess of the amount realized over the adjusted basis of such share. If the adjusted basis should equal or exceed the amount realized on the sale or exchange of a certain share of stock, bond, etc., there would be no gross receipts resulting from the sale of such security. Losses on sales or exchanges of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stock and securities. For the meaning of the term "stock or securities", see paragraph (b)(5)(i) of § 1.543-1.

In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1039

JOSEPH B. ZYCHINSKI AND MARIE H. ZYCHINSKI, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A, A-1 to A-13) are reported at 60 T.C. 950. The opinion of the court of appeals (Pet. App. B, A-14 to A-18) is reported at 506 F.2d 637.

JURISDICTION

The judgment of the court of appeals was entered on November 25, 1974, and its order denying rehearing was entered on December 17, 1974 (Pet. App. C, A-19). The petition for a writ of certiorari was filed on February 20, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Sections 1371-1379 (Subchapter S) of the Internal Revenue Code of 1954 generally permits the shareholders of certain qualifying small business corporations to elect to be taxed as if they were members of a partnership. Section 1372(e)(5) provides that the election shall terminate for any taxable year in which more than 20 percent of the corporation's gross receipts constitute "passive investment income," which is defined to include "gross receipts derived from * * * sales or exchanges of stock or securities* * * ."

The question presented is whether a corporate securities dealer's gains from the sale of securities constitute "passive investment income" within the meaning of Section 1372(e)(5) so as to terminate its Subchapter S election.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 1372 of the Internal Revenue Code of 1954 and of Section 1.1372-4 of the Treasury Regulations are set forth in the Appendix, *infra*.

STATEMENT

Petitioners owned all but 101 of the 4,000 shares of Henry J. Richter & Company. Petitioner Joseph B. Zychinski owned 100 shares of stock of the corporation and was its treasurer.[1] Prior to the commencement of its taxable year ended October 31, 1966, the corporation filed an election to be taxed as a small business (Subchapter S) corporation, and for its taxable years ended October 31, 1966 and 1967, filed its federal income tax reports on that basis (Pet. App. A, A-3).

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[1]Marie H. Zychinski is a party solely because she filed joint income tax returns with her husband for the years at issue.

During those years, the corporation was in the securities business. The greater part of its activities was the purchase and sale of securities for its own account, for and from the inventory which it maintained for that purpose. The majority of those sales were "wholesale" sales to broker-dealers.

In accordance with the practices of the securities industry, the corporation "made a market" in over-the-counter securities by publishing and advertising in trade circles that it would buy or sell such securities from or to other securities dealers; as a qualified securities dealer, it was required to make purchases and sales in accordance with those offers. As a result, the corporation purchased, sold and maintained an inventory of 50 to 100 different securities traded in the over-the-counter market, maintained offers to purchase and sell listings in the listings service (the "pink sheets"), and advertised in trade journals and newspapers. It also made some "retail" sales to buyers who were not broker-dealers. The corporation was registered with the Securities and Exchange Commission as a broker-dealer, was a member of the Midwest Stock Exchange and the National Association of Securities Dealers (Pet. App. A, A-4, A-6).

During the taxable years in issue, the corporation's principal income was approximately $231,000 in net gains from trading in securities for its own account, which far exceeded 20 percent of the Company's gross receipts. However, it did not purchase any securities for "investment" during those years and it reported no sales of securities as capital transactions (Pet. App. A, A-5).[2]

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[2]Section 1236 of the Code allows a dealer in securities to segregate those securities held for investment and not held primarily for sale to customers in the ordinary course of his trade or business, provided the dealer identifies them as held for investment and maintains adequate accounting records. The effect of Section 1236 is to allow a dealer in securities to report transactions in investment securities as capital transactions.

On audit, the Commissioner of Internal Revenue determined that the Subchapter S election of the corporation had terminated, because more than 20 percent of its gross receipts were from "passive investment income," which Section 1372(e)(5)(C) of the 1954 Code defines to include gains "derived from sales or exchanges of stock or securities * * *." As a result, he disallowed petitioners' claimed deductions of their pro rata shares of the corporation's losses. The Tax Court upheld the Commissioner's determination (Pet. App. A, A-7 to A-13) and the court of appeals affirmed (Pet. App. B, A-14 to A-18).

ARGUMENT

1. Section 1372(a) of the Code provides that "any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter." Generally, the effect of such a "Subchapter S" election[3] is that the corporation is not subject to the income tax but that its net income or operating loss is reportable pro rata by its shareholders as if they were members of a partnership (Sections 1373(a), 1374(a)). Section 1372(e)(5), however, provides that a corporation's Subchapter S election shall terminate if, after its first two years of engaging in a trade or business, its "passive investment income" exceeds 20 percent of its gross receipts. Section 1372(e)(5)(C) defines "passive investment income" as "gross receipts derived from * * * sales or exchanges of stock or securities" to the extent of the gains therefrom. Treasury Regulations, Section 1.1372-4(b)(5)(x), Appendix, *infra*, p. 12, makes the "passive investment income" limitation explicitly applicable to securities dealers, by providing that —

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[3]Sections 1371-1379 comprise Subchapter S of Chapter 1 of Subtitle A of the Code, and are commonly referred to as "Subchapter S."

> Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities.

Here, it is undisputed that the corporation's gains from sales and exchanges of stock or securities exceeded 20 percent of its gross receipts. Thus, under the Code and Regulations, the court of appeals correctly concluded that the corporation's gross receipts from such sales were "passive investment income" under Section 1372(e)(5)(C) so that its Subchapter S election terminated. In providing that gains from the sale of securities by securities dealers are included in the statutory term "sale or exchange of stocks and securities," the Regulation is "prima facie proper, comporting * * * with the ordinary understanding" of the statutory term. *Bingler* v. *Johnson*, 394 U.S. 741, 751. See also *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501. Since the statute was reenacted in 1966, Congress is deemed to have approved the Regulation. See, *e.g.*, *United States* v. *Correll*, 389 U.S. 299, 305-306; *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Fribourg Nav. Co.* v. *Commissioner*, 383 U.S. 272, 283.

Petitioners argue (Pet. 6) that the general term "passive investment income" in Section 1372(e)(5) was not meant to cover gains from the sale of securities by a corporation actively engaged in dealing in securities. Nothing in the statute or its legislative history supports that conclusion. The term "passive investment income" cannot be interpreted in a vacuum, as petitioners would do, and given a colloquial meaning that would exclude income from "active" business from the 20 percent rule. See *Western Union* v. *Lenroot*, 323 U.S. 490, 502; *Fox* v. *Standard Oil Co.*, 294

U.S. 87, 95-96.[4] To the contrary, "passive investment income" is a technical term defined with precision in Section 1372(e)(5)(C) to include various items, including "gross receipts derived from * * * sales or exchanges of stock or securities * * * ."

2. The courts have generally held that the specific types of income set forth in Section 1372(e)(5)(C) are subject to the 20 percent rule, without regard to the degree of passiveness of the corporate business operations. Thus, for example, the Ninth Circuit has held, in conformity with the decision below, that the gross receipts of a corporate securities dealer from gains from the sale of securities cannot exceed 20 percent of its total gross receipts without termination of its Subchapter S election. *Buhler Mortgage Co.* v. *Commissioner*, 443 F.2d 1362, affirming *per curiam*, 51 T.C. 971. To the same effect are *Marshall* v. *Commissioner*, 510 F.2d 259 (C.A. 10), and *Doehring* v. *Commissioner*, 33 T.C.M. 1035, decided September 10, 1974, appeal pending, C.A. 8, No. 75-1148, both of which held that interest income of a small loan company was subject to the 20 percent maximum limitation of Section 1372(e)(5)(C).[5]

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[4]There is no basis to petitioners' further argument (Pet. 11-12) that the active-passive test is embodied in another Regulation (Section 1.1372-4(b)(5)(vi)) under Section 1372(e). That Regulation deals with the entirely different problem of what portion of a payment is for rent—*i.e.*, "Consideration paid for use or occupation of property" (Black's Law Dictionary (Rev. 4th ed.), p. 1461)—and what portion is for services. The Regulation excepts payments from the statutory term "rent" if they are in exchange for "significant" services, although the courts have held that this exception is to be narrowly interpreted (*City Markets, Inc.* v. *Commissioner*, 433 F.2d 1240 (C.A. 6); *Bramlette Building Corp.* v. *Commissioner*, 424 F.2d 751 (C.A. 5)). Here, however, no comparable allocation problem exists since all of the receipts were within the statutory term "gross receipts derived from * * * sales or exchanges of stock or securities."

[5]The same rationale has been employed by the Second Circuit in interpreting Section 23(g)(4) of the 1939 Code, which limited loss deductions on stock to corporations whose income was derived "from sources other than * * * interest * * * or gains from sales or exchanges of stock or securities." 26 U.S.C. (1952 ed.) 23 (g)(4). The court held that this limitation applied to banks, regardless of the fact that the bank in question was an "operating" company. *Commissioner* v. *Adam, Meldrum & Anderson Co.*, 215 F.2d 163, certiorari denied, 348 U.S. 913.

Petitioners contend (Pet. 6) that the decision below conflicts with *House* v. *Commissioner*, 453 F.2d 982 (C.A. 5). There, the court held that the pre-1966 version of Section 1372(e)(5) did not affect gross receipts from interest received by a corporation in the small loan business. In the court's view, the 20 percent rule did not apply to such a corporation because the then-existing descriptive title of the statute was "Personal Holding Company Income" and the taxpayer came within a specific exception to the definition of "personal holding company" for a corporation engaged in "the active and regular conduct of a lending or finance business." See Section 542(c)(6) of the Code.

There is no conflict of decisions warranting review by this Court. Unlike *House*, this case involves the post-1966 version of Section 1372(e)(5), in which the descriptive title was changed to "Passive Investment Income." Although the committee reports indicate that this change of terminology in the title was not intended to alter the meaning of the statute (see S. Rep. No. 1007, 89th Cong., 2d Sess. 20 (1966)),[6] the fact that the Fifth Circuit in *House* relied upon the now-eliminated descriptive title "Personal Holding Company Income" effectively distinguishes that case. Here, in contrast to *House*, there is no comparable specific exception in the personal holding company provisions applicable to petitioners for income received by securities dealers from gains from the sale or exchange of stock or securities.[7] Thus, even assuming *arguendo* that the

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[6]Indeed, Section 7806(b) of the Code explicitly provides that such descriptive matter in the statutory titles is not to be given any legal effect.

[7]Prior to 1964, Section 543(a)(2) had defined "personal holding company income" to include gains from sales or exchanges of stock or securities "[e]xcept in the case of regular dealers in securities * * *." 26 U.S.C. (1958 ed.) 543(a)(2). However, that substantive provision was eliminated by Section 225(d) of the Revenue Act of 1964, Pub.L. 88-272, 78 Stat. 81.

personal holding company provisions continue to offer a relevant guide to the construction of the post-1966 version of Section 1372(e)(5), the rationale of *House*, which heavily relied upon the specific exception in the personal holding company provisions, would not apply to this case,[8] where the corporation was not a personal holding company simply because it had no "personal holding company income". See Section 543(a) of the Code. In sum, while the Fifth Circuit may continue to follow *House* with respect to finance companies,[9] it has not yet extended the rationale of that case to exempt any corporation that is not a personal holding company from the 20 percent rule of Section 1372 (e)(5).[10]

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[8]The Fifth Circuit in *House* also relied upon the district court's decision in *Valley Loan Association* v. *United States*, 258 F. Supp. 673 (D. Colo.), which the Tenth Circuit disapproved and effectively overruled in *Marshall* v. *Commissioner*, *supra*.

[9]The Fifth Circuit will shortly have an opportunity to reconsider its holding in *House* in the context of a pre-1966 case. See *Puckett* v. *Commissioner*, 33 T.C.M. 1038, decided September 10, 1974, appeal pending, C.A.5, No. 75-1913, where the Tax Court upheld the taxpayer's position. While the Tax Court reached a contrary result in *Doehring* v. *Commissioner*, *supra*, 33 T.C.M. 1035, decided September 10, 1974, appeal pending, C.A. 8, No. 75-1148, the divergency of results is a consequence of that court's application of its *Golsen* rule (*Golsen* v. *Commissioner*, 54 T.C. 742, 757, affirmed, 445 F.2d 985 (C.A. 10), certiorari denied, 404 U.S. 940), pursuant to which it decides cases in conformity with the law of the applicable circuit to which an appeal might be taken. Since the Fifth Circuit has already ruled on the issue in *House*, the Tax Court held for the taxpayer in *Puckett*. However, because the Eighth Circuit has not ruled on a pre-1966 case involving a finance company, the Tax Court in *Doehring* felt free to apply the rule of its own prior decisions in favor of the Commissioner. Contrary to petitioner's argument (Pet. 12), this divergence of results by the Tax Court is not a conflict of decisions warranting review by this Court.

[10]We are advised by the Internal Revenue Service that the issue does not presently have any significant administrative importance. Apart from the *Puckett* and *Doehring* cases, there are no other cases pending in the courts presenting this issue. There are a total of six cases pending administratively, in which the total amount of taxes at stake is approximately $380,000.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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MAY 1975.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 1372 [as added by Sec. 64(a), Technical Amendments Act of 1958, Pub.L. 85-866, 72 Stat. 1650]. ELECTION BY SMALL BUSINESS CORPORATION.

* * * * *

(e) *Termination.*—

* * * * *

(5) [as amended by Sec. 3(a), Act of April 14, 1966, Pub.L. 89-389, 80 Stat. 114] *Passive investment income.*—

(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

(ii) the amount of passive investment income for such taxable year is less than $3,000.

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ *1.1372-4 Termination of election.*

(b) Methods of termination— * * *

* * * * *

(5) *Passive investment income*— * * *

* * * * *

(vi) *Rents.* The term "rents" as used in section 1372 (e)(5) means amounts received for the use of, or right to use, property (whether real or personal) of the corporation. The term "rents" does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat and light, the

cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally "rents" under section 1372(e)(5). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments.

(x) *Gross receipts from the sale of stock or securities.* For purposes of section 1372(e)(5), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess of the amount realized over the adjusted basis of such share. If the adjusted basis should equal or exceed the amount realized on the sale or exchange of a certain share of stock, bond, etc., there would be no gross receipts resulting from the sale of such security. Losses on sales or exchanges of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities. For the meaning of the term "stock or securities", see paragraph (b)(b)(i) of § 1.543-1.